AMSEL-LG February 25, 1998

MEMORANDUM FOR Chief Counsel

SUBJECT: Due Diligence

1. The purpose of this memorandum is to discuss the various definitions of the term "due diligence." This term takes on a myriad of meanings in both the financial and legal realm. Its definition encompasses both its use as a legal defense, as well as a term for the investigation process done prior to, *inter alia*, corporate acquisitions, initial public stock offerings or acquisition of real property. The term “due diligence” is used in many different legal areas and regulations, however, this memorandum will focus upon “due diligence” in the corporate world.

2. At its most basic meaning "due diligence" is defined as "such a measure of prudence, activity, or assiduity as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances, not measured by any absolute standard, but depending on the relative facts of the special case." Black's Law Dictionary 457 (6th ed. 1990). However, in the business world, “due diligence” has a different, but related meaning. Corporations and individuals often perform "due diligence" investigations prior to making business decisions. Often these investigations are done to analyze the risks, assets and liabilities, of a project, acquisition or venture. In essence, in the business world a "due diligence" investigation is often linked to risk management. In turn, this process has become a legal defense often used by *inter alia*, underwriters, corporations and venture capitalists when being sued by investors, fiduciaries and shareholders. Often, due diligence is used as an affirmative defense that a fiduciary duty has been satisfied.

3. One area where the "due diligence" process is used is in the merger and acquisition realm. For instance, when acquiring privately held corporations a routine practice is something called an “acquisition review,” which is very similar to a “due diligence” review. Committee on Negotiated Acquisition, *Purchasing the Stock of Privately Held Company: The Legal Effect of an Acquisition Review*, 51 Bus. Law. 479(1996). Generally, this involves the acquiring corporation's business, financial and legal advisors assessing the corporation to be acquired (target company). Id. This review usually consists of two phases: one prior to executing a definitive acquisition agreement and a second before the execution of a letter of intent. Id. The first phase, generally conducted by business and financial advisors, focuses on the target corporation’s financial and business condition "with a view towards evaluating the business as a basis for negotiating the business terms of the transactions." Id. The second phase continues this evaluation and also includes a "legal audit," "analyzing (the Target's) pending litigation, examining leases and contracts from a legal standpoint, checking (the Target's) charter documents and minutes book, and so forth." Id. This review is considered very similar in scope to a "due diligence" review done in conjunction with a public offering of stock, discussed *infra*. Id. Thus, this type of review is a form of “due diligence" by an acquiring corporation.

4. This same acquisition review or “due diligence” investigation, for business purposes, applies to a commercial corporation's acquisition of a government contractor. For instance, in an article pertaining to such an acquisition, the article suggests that such due diligence review "allows for a reasonable assessment and management of risk in acquiring or merging with a company doing business in the government market." Steven S. Diamond, *Acquiring a Government Contract in Technology Based Industries: Critical Issues for the Due Diligence Review and Risk Assessment*, 68 F.C.R. 1930 (1997). In this context “due diligence” is used as a tool

for assessing a target company's assets and liabilities, but more importantly, as a means of conducting risk management. Specifically, such a review is used to:

> (1) identify key issues that may facilitate a more realistic valuation of the business to be acquired or whether the acquisition even makes sense;
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> (2) provide an assessment of the viability of the business to be acquired as an ongoing concern;
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> (3) identify agencies and contact points for required government approvals; and
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> (4) provide information necessary to negotiate representations and warranties, indemnifications, and other contract covenants and conditions. Id.

Therefore, in this context a "due diligence" investigation is not only used as a legal defense, but as a business decision tool.

5. "Due Diligence" investigation is also used in asset securitization and finance. A suggested sample "due diligence" document checklist should include the following:

> a) Corporate records (i.e. articles of incorporation, description of legal ownership of the company and equity investments, annual reports etc.);
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> b) Arrangements with affiliates (i.e. business arrangements entered into by the company with officers, employees or directors);
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> c) Financing arrangements (loan and credit agreements, promissory notes, registration statements, documentation of contingent liability);
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> d) Legal proceedings (a listing of all litigation or arbitration proceedings, etc.);
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> e) Governmental regulations and filings or Compliance matters (SEC reports, governmental permits, licenses, correspondence regarding compliance with agencies and environmental audit reports, etc.);
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> f) Material agreements (material contracts, insurance agreements, etc.);
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> g) Tax matters (liabilities, filings, etc.);
>
> h) Properties (all leases and agreements regarding them);
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> i) Intellectual property (all trademarks, copyrights, patents, licensing agreements, etc.);
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> j) Environmental (audits, reports, consultants); and
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> k) Other documents (analysis by management consultants, financial statements, and accounting reports, etc.). Charles E. Harrell, *et. al*., *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financial Techniques*, 52 Bus. Law. 885 (1997).

6. "Due diligence" also plays an important role in securities regulations. Securities are governed by the Securities Exchange Act of 1934, 15 U.S.C. § 78 *et.seq*. (hereinafter "1934 Act") and Securities Act of 1933, 15 U.S.C. 77a *et. seq*, (hereinafter "1933 Act"). Generally, the 1933 Act pertains to securities registration

and disclosure requirements regarding stock offerings, while the 1934 Act, *inter alia*, applies to publication of securities' information which is traded either via stock exchanges or over the counter trading. Shareholders, fiduciaries or the Securities and Exchange Commission (hereinafter "SEC"), often sue regarding this information, for fraud, misrepresentation or omission of material facts. This is because the Securities Acts often require corporations to disclose certain information, including financial and legal, to the public. It is this disclosure or non-disclosure of information, as well as its veracity, that is often the basis of lawsuits.

7. Prior to a public securities offering, a "due diligence" investigation is performed "to verify all disclosures for accuracy and completeness." C. Schneider, *Going Public: Practice, Procedure and Consequences*, 27 Villanova L. Rev. 1 (1981). Further, "[h]istorically, underwriters in registered offerings conducted an extensive due diligence investigation of the issuers and its business, worked side by side with the issuer, their respective counsel, and the issuers' accountants in the preparation of the prospectus…." Robert F. Quantance, Jr., *How to Stop Arguing about 10b-5 Opinions in Exempt Offerings*, 51 Bus. Law. 703 (1996). It is often this investigation which underwriters use as a "due diligence defense" to securities fraud actions. Id. Thus, "due diligence" in this sense is used to protect against potential shareholder suits. Often, a shareholder brings suit for a material misstatement or omission not only in registration statements, but also, *inter alia*, in proxy materials, required SEC financial reports and advertising materials. Under Dirks v. SEC, 463 U.S. 646, 653 (1983), the standard for proving a stock fraud case is that the plaintiff must prove the following: (1) a misrepresentation; (ii) the existence of a duty; (iii) scienter; (iv) materiality; (v) reliance and (vi) injury. A proper "due diligence" investigation would be an affirmative defense. Escott v. Barchris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). Section 11(b) of the 1933 Act, provides that a "due diligence defense" may be used when someone other than an issuer of stock, can show they "had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statement therein not misleading." Id. Paradoxically, a defendant may accuse a plaintiff of not exercising "due diligence" prior to his purchase of a security. In fact, failure of the plaintiff to exercise such "due diligence" is also often used as an affirmative defense. Committee on Negotiated Acquisition, *Purchasing the Stock of Privately Held Company: The Legal Effect of an Acquisition Review*, 51 Bus. Law 479 (1996).

8. One of the things that a proper "due diligence" securities review involves is proper accounting methods. The Financial Accounting Standards Board (hereinafter "FASB") promulgates standards for financial accounting and reporting, which are often utilized by the Securities and Exchange Commission in examining various corporate documents, such as filings and proxy statements. For instance some areas that the FASB provides accounting guidance on are "Employers' Disclosures about Pensions and Other Postretirement Benefits," FASB No. 132, and "Employers' Accounting for Postemployment Benefits" FASB No. 112. Using these guidelines, in addition to their own, the SEC determines whether a firm has made adequate financial disclosures.

9. Another area where "due diligence" investigation is often used is in the acquisition of real property. The acquisition of real property can often lead to potential liability for environmental violations if there is a failure by the purchaser to perform an adequate environmental "due diligence" investigation. Often, a defense to such liability, can be made by a defendant's assertion that it performed a proper "due diligence" investigation prior to obtaining the property. When examining whether this standard has been met, "the court will consider any special knowledge or experience held by the purchaser, credibility of the purchase price, reasonably ascertainable information regarding the property and the likelihood of

contamination and the ability to detect it." Sean Sweeney, *Owner BEWARE: Lender Liability and Cercla*, 79 A.B.A.J. 68 (1993).

10. Often "due diligence" environmental investigations involve hiring an environmental consultant to do an investigation and to compare environmental clean up costs versus the purchase price and any "benefits of purchasing an ongoing operation". Ronald E. Cardwell & Jack D. Todd, *Buying, Selling or Closing A Facility: A Summary of Environmental Issues*, 9 S. Carolina Law. 14 (1997). An environmental “due diligence” investigation, which is very similar to the previously discussed “due diligence" investigations, is traditionally “comprised of four segments - a records review, a physical facility reconnaissance, interviews with current owners and operators and an evaluation and report. A due diligence team should be comprised of the buyer's in-house representative, environmental consultant and environmental lawyer and, if appropriate and beneficial to the buyer, the sellers' representatives." Id. Additionally, another important aspect to consider when doing such an investigation is to do so in a proper time frame. Id.

11. This environmental "due diligence" check is often a key component of more traditional "due diligence" analysis. Sylvia Harrison , *Environmental Due Diligence in Real Property Transactions: Practice Pointers*, 5 Nevada Law. 20 (1997). Specifically:

> The purpose of environmental due diligence is to assess the environmental condition of the property to determine the level of environmental risk associated with the transaction, and to evaluate possible constraints on the planned use of the property imposed by the environmental condition of the property. This is easier to describe than to implement. No standards exist governing environmental due diligence, and indeed no single due diligence routine can be devised that is appropriate to all transactions. Adequate environmental due diligence involves far more than ascertaining whether there are hazardous substances on a property. Simply arranging for the performance of an environmental assessment does not fulfill the requirements of environmental due diligence. The major prongs of an environmental due diligence inquiry can be summarized in three words: "conditions," (property conditions), "compliance" (compliance with governmental regulations), and "constraints" (how environmental conditions may prohibit the intended use of a property). Id.

Another sample "due diligence" guideline, this for environmental, lists the following as important to performing satisfactory “due diligence”:

> (1) Compliance policies, standards and procedures to meet such policies; (2) Mechanisms for implementing policies; (3) Communicating standards and procedures to agents and employees; (4) Giving managers and employees incentives to conform with policies; and (5) Procedures for prompt action for compliance violations. Dara B. Less, *Incentives for Self-Policing: The Need for a Rule*, 2 Envtl. Law. 753 (June 1996).

12. Environmental “due diligence” investigations are also related to federal securities disclosure laws. For instance, in examining corporate security filings, the SEC Commissioner stated, " When the Staff finds material omissions or deficiencies relating to environmental matters, it will continue to request corrective disclosure and, in egregious cases, to refer the matter to the Commission's Divisions of Enforcement for appropriate enforcement consideration." Richard Y. Roberts, *et. al*, *Environmental Liability Disclosure and Staff Accounting Bulletin No. 92*, 50 Bus Law Journal 1 (1994). In connection with environmental financial disclosures the SEC has released their own accounting guidelines in Staff Accounting Bulletin No. 92 (SAB92), based on FASB regulations (the FASB was discussed *supra*). Under FASB

and SAB guidelines, certain contingent environmental liabilities must be recognized in corporate accounting statements and adequately disclosed. Id. Failure to adequately disclose such information can lead to lawsuits for misrepresentation or omission of material facts. By performing adequate “due diligence” investigation of potential environmental contingent liability and disclosing them, these lawsuits may be avoided.

13. The term "due diligence" is also often associated with corporate compliance programs, which not only attempt to protect a corporation from civil liability, but also criminal liability. Specifically, "[a] compliance program's primary goal is to prevent wrongful conduct. Accordingly, an effective program must first identify the potential legal risks facing a business organization." Gardner Davis and Jeff McFarland, *Corporate Compliance Program: Protecting the Business From the Rogue Employee*, 70 Fl. Bar Jnl. 34 (1996). A compliance program, which is currently in existence, provides another important purpose: a court must use it as a mitigating factor when determining criminal penalties. Id. A compliance program is considered effective when there is an appropriate level of "due diligence." Id. Some suggested "due diligence" guidelines, which are once again similar to previously discussed standards, are:

> (1) The established standards and procedures must be reasonably likely to reduce the likelihood of criminal conduct;
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> (2) A 'high level' individual in the company must be responsible for the program;
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> (3) An employee who is not ethical must not be placed in charge of the program;
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> (4) Employees must have knowledge about the program;
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> (5) The compliance standards are enforced, consistently and evenly; and
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> (6) There is a quick response to discovered offenses. Id.

14. Another business context where “due diligence” is used is when entities have been sued for breach of contract and fraudulent inducement. Once again "due diligence" is used as a defense to such suits. For example, in Banque Arabe Et Internationale D' Investissment v. Maryland National Bank, 850 F. Supp 1199 (1994), the plaintiff sued the defendant for fraudulently inducing a purchase of a real estate loan participation interest, "by failing to disclose material information and by making material misrepresentations prior to execution of a participation agreement." Id. at 1199. The plaintiff had conducted a “due diligence” investigation and credit analysis prior to executing the agreement. Id. at 1203. However, the plaintiff alleged that the “due diligence” investigation was insufficient and misleading because the defendant had made material misrepresentations and omissions. Id. at 1215.

15. When alleging common law fraud a plaintiff must demonstrate: (1) there was a material false representation or omission of an existing fact; (2) made with knowledge of its falsity; (3) with an intent to defraud; and (4) reasonable reliance (5) that causes damage to the plaintiff." Id. Information is material if "it would have assumed actual significance in the deliberation of the reasonable purchaser." Id. at 1217. Scienter is defined as the "intent to deceive, manipulate or defraud." Id. at 1225. In another loan participation agreement, a plaintiff sued the defendant because of fraudulently misrepresenting that it had conducted a due diligence examination prior to entering into an agreement. Great Western Capital

Corporation v. Ingersoll-Rand Corporation, *et. al*, 1997 U.S. App. Lexis 2864 (9th Cir. 1997). Once again, as in securities fraud cases, "due diligence" was linked to a breach of fiduciary trust. Id. In this case "due diligence" investigation was to have included examination of credit records, loans, and spot checks on partnerships. Id. Additionally, the "due diligence" standard has been applied to the fiduciary duty of trustees in New Jersey. Robertson v. Central Jersey Bank & Trust Company, 47 F3rd 1268 (3rd Cir. 1994)

16. Another context, in which “due diligence” is used, is a two-phase government acquisition of capital assets. In the first stage of such an acquisition the agency asks for information typically about "past performance and experience, a conceptual outline of the proposed technical approach (versus a particular technical solution), and a rough order of magnitude of pricing." "Planning, Budgeting & Acquisition of Capital Assets," Supplement to OMB Circular A-11, Section III.3.2. This allows the agency to advise potential offerors whether they are an award contender. Id. Subsequently, a solicitation is issued in the second phase. Id. The intent of such an effort is that "communications will foster the development of requirements and evaluation criteria that allow the best fit between agency needs and marketplace capabilities. Sources that are advised based on the first phase review that they are strong competitors should be encouraged to participate in such a due diligence effort." Id. In general, "[t]wo-Phased acquisition provides incentives to bidders to invest more of their own resources to perform due diligence to learn about agency needs and develop innovative high value solutions." Id. In essence, “due diligence” in this context appears to relate to communications between the government and offerors and the efforts of offerors to understand agency requirements.

17. Finally, the term "due diligence" also pertains to simple negligence matters. “Due diligence” is often the standard required to rebut a charge of negligence. For instance, the only mention of the term "due diligence" in acquisition regulations is DFARS 252.247-7007, "Liability and Insurance Clause." In it the contractor is required to exercise due diligence to discover defective equipment. This type of "due diligence" negligence issue most likely has little relevance to the present matter.

18. As shown above, "due diligence" is used in many different contexts. Primarily, in all contexts, it is used as a legal defense, as well as a business decision making process. As a business process, due diligence is essentially used to examine business opportunities, and their associated risks and liabilities. Often such "due diligence" investigations or reviews encompass examination of potential legal liabilities. Finally, these "due diligence" investigations not only serve as a valuable business tool, but also are often used as affirmative defenses to law suits.

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